CHASE

International Finance

Vol. XVII, No. 15
August 2, 1982

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

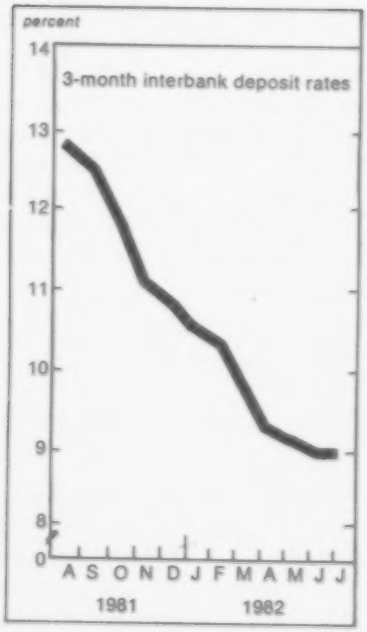
B1900-1 8/3/82

German Monetary Policy Likely to Ease

Recent developments in Germany and in the world economy suggest that another easing of German monetary policy will occur soon. Not only have inflationary pressures—both homemade and imported—subsided, but also the German economy is proving much weaker than had been anticipated only a few months ago.

Germany's domestic inflation problems were aided by the 1981-82 wage round, which brought pay rises of about 4%. These are now being reflected in a year-on-year growth rate of industrial unit labor costs of only 2.5%. Moreover, consumer price increases slowed in the first half of the year. Excluding the June number, which was raised by higher indirect taxes, the consumer price index rose at a seasonally adjusted annualized rate of only 3.6% during the first five months.

German interest rates



Imported inflation has fared even better. Import prices in terms of the mark actually declined in the first half of 1982 and, by June, were 0.4% below the level of June 1981—despite a 7.6% decline in the DM against the dollar between December and June. This improvement in the face of a strengthening dollar reflects primarily the fall in dollar-denominated commodity prices—down by some 18% in the twelve months to July—but also the revaluations of the DM within the European Monetary System.

Germany's real economy, however, has been disappointing. Real GNP declined slightly in the first quarter, and domestic industrial order volume continues to drift down. In addition, orders from abroad, which softened the recession last year, have fallen sharply over the past three months.

Over the course of 1981, the Bundesbank held interest rates higher than was justified by short-term growth considerations, ostensibly in order to finance Germany's current-account deficit but more fundamentally to dampen inflation by upholding or at least cushioning the DM exchange rate. The easing of dollar-denominated inflation, however, now substantially reduces the inflationary cost of a weaker DM against the dollar at a time when domestic inflationary pressures are also receding.

These trends, coupled with the recent declines in U.S. interest rates, suggest that a further fall in German interest rates is in the offing. Unfortunately, however, such a shift is not entirely riskless. Germany's targeted money stock, Central Bank Money, has been growing at the upper end of its 4%-7% target range. If lower interest rates result in faster money-supply growth, a shift in inflation expectations could ultimately result in a fall in German long-term bond prices.

© 1982—Economics Group, The Chase Manhattan Bank, N.A.

Worsening of inflation poses problems for Swiss franc.

Switzerland's rate of inflation has stepped up sharply since the end of the first quarter. The consumer price index advanced at an annual rate of 11.5% in the second quarter and in June stood 6.2% above its year-ago level. This represents a worsening relative to inflation in Germany—Switzerland's major trading partner. The deterioration in the Swiss inflation picture was due, in part, to the Swiss National's Bank's relaxation of monetary policy at the beginning of the year, which contributed to a weakening of the exchange rate and increased import costs. Since January, the Swiss franc has fallen 17% against the dollar and 6% against the mark. In addition, however, underlying cost pressures have remained a relative burden for the Swiss, as unit labor costs have risen by some 6% over the past year against less than 3% in Germany. Given added cyclical forces, pressure on the Swiss franc against the mark is expected to continue for the time being. But since Swiss monetary policy has now turned more cautious, these pressures are likely to be reflected in relative interest rates between the two countries.

Progress made toward improving long-term prospects for Belgian economy.

Despite indications that Belgium's recovery will be delayed until early 1983, considerable progress has been made toward correcting some of the country's more fundamental economic imbalances in the seven months since the December 1981 general elections. Last year, the country's current-account deficit exceeded 7.5% of GNP, the public sector deficit rose to 15.3% of GNP, and unemployment was rising rapidly. The new government obtained special powers to loosen wage indexation and to modify the tax and social security structure. The devaluation of the Belgian franc—together with subsequent realignments of the EMS and a stronger U.S. dollar—led to an estimated 10% devaluation in the effective exchange rate. Although this is likely to raise Belgium's inflation rate to an average of 10% this year, the relaxing of indexation ensures that real wages will fall by at least 4%, suggesting improvements in export competitiveness and in longer-term prospects for employment.

Escudo devaluation aims to provide boost to Portuguese exports.

Portugal's highly open economy has been hard hit by the current world slowdown. In 1981, with European demand for textiles weak, export receipts declined 11.2% in dollar terms. Furthermore, a severe drought added as much as 5% to the import bill because of increased purchases of food and fuel. This, combined with sluggish tourism and the adverse impact of high interest rates, resulted in a current-account deficit of $2.6 billion in 1981, some 11% of GDP, and more than double the 1980 gap of $1.25 billion. With export demand remaining depressed it is unlikely that the deficit will decline to substantially less than $2 billion in 1982. Meanwhile, Portuguese inflation returned to 25% in the spring, prompting the authorities to use the occasion of the June EMS realignment to devalue the escudo by 3.75% against the French franc while maintaining the 0.75% monthly crawling peg adjustment. This should improve Portuguese export competitiveness in advance of the long-awaited world recovery.

Colombian economic activity at a low but expected to pick up soon.

Colombia is currently experiencing a lull in economic activity. Unemployment, according to the latest available data, climbed to 9.7% in March, compared to a year-earlier level of 9.1%, largely because of declines in construction and business investment. The foreign trade sector has also been drifting. Up until mid-May exports were down 10% from a year ago. And with imports rising about 4%, international reserves fell to $4.2 billion in May from $4.7 billion (minus gold) at the end of 1981. The government has sought to offset these downward influences, however, through stimulative actions, including stepped-up deficit spending and increased financial liquidity for business. In addition, activity in the natural resources is on the rise. Domestic oil output has gone up 15% in the past two years and in 1981 a record number of exploratory wells were drilled. Also, the vast Cerro Matoso nickel project started production last month. These various production indicators suggest a real GDP advance of about 3% in 1982—below Colombia's potential but impressive compared to the depressed conditions in some of the other Latin American countries.

Further widening of current-account deficit projected for Pakistan.

Pakistan's balance of payments suffered a marked deterioration in the just-ended fiscal year 1981-82, owing to the combined effects of the depressed state of the world economy, a steep decline in cotton and rice prices, a sharp slowdown in the growth of workers' remittances, and an appreciation of the rupee arising from its link with the strong dollar. Exports dropped an estimated 12% from the previous year. And although imports showed only a slight increase, the current-account deficit widened to some $1.43 billion or 4.6% of GDP from $991 million or 3.5% of GDP in fiscal 1980-81. Reserves fell an estimated $159 million, in sharp contrast to the $310 million increase the previous year. The current year's balance-of-payments outlook depends largely on the timing of recovery in the world economy and in the commodity markets. However, even assuming some rebound in cotton prices and a boost to Pakistani exports of manufactured goods—arising from last January's devaluation and the subsequent rupee depreciation—the current-account deficit is projected to widen to perhaps $1.64 billion or 5.5% of GDP in fiscal 1982-83.

Australian government hopes to improve money-supply control with new debt procedures.

Concern over its inability to control the domestic money supply has prompted the Australian government to change the way it issues bonds. On June 25, the government announced that, soon, a predetermined quantity of bonds will be offered for sale at market prices, probably every two months. Under the current system, securities are continuously offered for sale to all buyers at predetermined rates. Because of the government's past reluctance to offer realistic yields, however, too few bonds have been sold. This has hampered attempts by the monetary authorities to keep money growth within bounds. They have exceeded their monetary targets in each of the last three years, and are in danger of doing so again this year. Consequently, forecasters are currently predicting 11% inflation for 1982 and the Australian dollar has fallen sharply against the U.S. dollar. Policymakers are hopeful the planned revisions in bond issuance procedures will improve monetary control and thus help to remedy these problems.

Unprecedented deficits for South Africa's current account.

A sharp fall in the average price of gold and a 13% jump in import payments resulted in a severe balance-of-payments deterioration for South Africa in 1981. The trade account registered a $7.5 billion swing into a $464 million deficit that was paralleled by a $7.9 billion reversal in the current account—from a $3.5 billion surplus in 1980 to a $4.4 billion deficit last year. In the first quarter of 1982, further declines in the price of gold and high merchandise import prices boosted the current-account deficit to $6.7 billion, at a seasonally adjusted annual rate. The current stagnation of the South African economy, however, should help mitigate the apparent deterioration in the balance of payments somewhat in the remainder of the year as import volume contracts. Nevertheless, assuming an average gold price of $330/oz for the year, the current-account deficit can be expected to fall near a range of $5.5-6.0 billion.

New tin pact heightens uncertainty over market outlook.

Last month's adoption of the Sixth International Tin Pact has increased the difficulty of predicting tin production and prices. Eight countries that signed the previous agreement have rejected this one, including the United States, the largest consumer, and Bolivia, the fourth largest producer. This lack of participation suggests that the market interventions and production restrictions called for by the International Tin Agreement (ITA) may be insufficient to defend the 6.9% increase in the new floor price to $5.62/lb.—especially considering the current excess supply. World production of tin in 1981 exceeded consumption by over 51,000 tons, pushing current world inventories to an estimated 240,000 tons —almost 150% of last year's consumption. And the glut is expected to continue. Tin demand has fallen sharply since 1978, not only because of the recessions in the industrial countries but also owing to an increase in the real price of tin that has prompted tinplate users to seek substitutes. In this environment, U.S. plans to dump 35,000 tons from its tin stockpile onto the world market by 1983 undoubtedly will have serious negative repercussions on future prices.

Can Balancing the Budget Be Made Simple?

President Reagan has added his voice to the growing chorus calling for a constitutional amendment requiring a balanced federal budget. Against the backdrop of sky-high interest rates, the near-breakdown of the budget process, and the threat of a 50% increase in the public debt in four years, it is not surprising that 31 states have requested a constitutional convention to consider this issue. To avoid opening this possible Pandora's box, however, Congress is likely soon to submit to the states some form of a balanced budget amendment to demonstrate its own concern about the magnitude of the prospective deficits.

Regardless of unanswered questions about the theory that links budget deficits to high inflation and high interest rates, the desire for reducing these magnitudes is clearly behind the current drive for a balanced budget amendment. Lower levels of inflation and interest rates are necessary to create a climate conducive to more stable and sustainable economic growth by increasing capital spending, labor productivity, and economic efficiency.

In general, the proponents of a balanced budget amendment view public spending as a burden on the economy because government uses resources less efficiently than the private sector. To minimize the loss of efficiency from the growth in government spending, most favor including a provision that would limit the growth in receipts in any fiscal year to the rate of increase in national income in the prior calendar year. Coupled with the requirement that the budget be balanced, this provision effectively places a limit on the growth of expenditures.

There are two possible shortcomings to this attempt to limit spending, however. First, because no distinction is made between a change in real income and a change in income resulting solely from inflation, government would still benefit from inflation by receiving greater revenue. Second, the lag in calculating the allowable increase between the current fiscal year and the previous calendar year means that, on average, fiscal policy would be procyclical. This means that, because growth in nominal national income usually increases during an expansion, the allowable rate of increases in taxes and spending would still be rising as the economy peaked and entered a recession. But as income growth slowed or fell during the recession, spending would have to be cut or taxes raised, worsening the recession.

While it might be politically comforting to have a constitutional rule for fiscal policy that would promise to produce what existing congressional processes have failed to deliver, difficulties would inevitably arise from oversimplification. Attempts to design a balanced budget rule have elicited criticisms from all sides:

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF				
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of credit, lions of
Austria	Mild recovery still expected this year; research institutes forecast 1983 growth at 2.5%-3%.	Jan.	+ 6%	65.8	0	May	4,647	+ 6%	2.7	
Belgium	Industrial production declined in first quarter; economy now not expected to recover before early 1983.	Feb.	0	96.1	+2%*	May	3,347	−51%	0.7	
Britain	Still few signs of sustained recovery in business conditions.	May	+ 4%	523.6*	−2%	May	13,436	−26%	1.5	17
Denmark	Industrial orders are still rising; business hoping for a good year.	March	0	64.7*	0 *	May	2,009	−23%	1.3	
Finland	Trough of current business cycle expected this year; little change in GDP likely.	April	− 1%	47.8	+1%	May	1,280	−18%	1.1	3
France	Austerity package, including wage-price freeze, worsens business prospects.	May	0	657.0*	+2%*	May	15,775	−47%	1.5	
Germany	Volume of foreign orders falls sharply, domestic orders slow; inflation set to decline.	May	0	689.4	0	May	42,471	−15%	3.1	
Ireland	Economic growth slowing in wake of tough measures imposed in recent government budgets.	Feb.	+ 2%	17.6*	+2%*	May	2,745	+19%	3.1	
Italy	Leading indicators turn down, increasing doubts about sustainability of recovery.	May	+ 2%	394.9*	+4%*	May	12,991	−19%	1.6	
Netherlands	General election to be held September 8; outgoing government proposes restrictive 1983 budget.	April	− 2%	167.4*	+1%*	May	8,796	− 6%	1.6	
Norway	Reduced offshore oil output will produce GDP decline but domestic activity will continue high.	April	+ 2%	55.6	+1%	May	7,261	+14%	5.2	
Portugal	Export weakness constraining growth.	Dec.	+ 3%	23.5*	+6%*	April	356	−25%	0.5	2
Spain	Inflation on a year-over-year basis up to 15.1% in May.	Dec.	− 1%	211.1*†	+1%*	April	9,303	−12%	3.5	8
Sweden	Economy set to grow in 1982, although May new orders were down 6% from year earlier.	April	− 4%	111.6	−1%	May	3,415	−17%	1.6	
Switzerland	Real GDP flat in first quarter compared with year earlier.	Dec.	+ 2%	97.8	+4%*	May	13,022	+25%	5.0	
Turkey	New chief economic policymaker will shortly publish economic program for next twelve months.	n. a.	n. a.	60.0	+4%	May	1,272	+41%	1.7	1,43
Canada	Business and consumer confidence at low levels as economy slows and inflation stays high.	May	−11%	274.0	+3%	June	2,148	−11%	0.4	
United States	Hopes for imminent recovery remain high although few concrete signs have yet appeared.	June	−10%	2,925.5	+2%	May	19,765	+ 8%	0.9	

†GDP *1980

It would be too binding, too difficult to implement, or too easy to override or circumvent.

One of the sharpest criticisms of the proposal is that it does not give policymakers sufficient discretion. Opponents argue that to require spending cuts and tax increases by law for the sake of a balanced budget during an economic downturn—when falling incomes act to reduce receipts and increase expenditures—would run the risk of worsening the recession. This policy could lead to a vicious cycle of deficit-widening and deficit-closing at the expense of the economy.

Critics further argue that implementation difficulties would arise because of long lead times in the budgetary process. By law, the President submits his budget proposals in late January or early February for a fiscal year that ends about 20 months later. By then, a changed economic environment could wreak havoc on a budget plan. As an example, in early 1980 the Carter administration submitted its budget proposals for fiscal 1981 showing a deficit of $16 billion. By the end of the fiscal year, however, the deficit had ballooned up to $58 billion—chiefly because of a worse-than-forecast recession.

A third criticism of the balanced budget amendment is that any version likely to pass Congress would probably be fairly easily overridden or circumvented. Congress would not want to place itself in such a fiscal straitjacket that a super majority could not escape, and suspension during times of war is taken for granted. Moreover, Congress could—as it has in the past—shuffle agencies between on-budget and off-budget status depending upon whether they were in surplus or deficit.

The most popular version of the balanced budget/receipts limitation amendment currently before Congress fails to overcome significantly any of the obstacles mentioned above. In addition, it calls for Congress to enact a balanced budget every year unless 60% of each chamber specifically votes in favor of a deficit, or in the event of war. Suspension of the receipts limitation requires only a simple majority vote or a declaration of war. The ease of this escape provision substantially dilutes the likely effectiveness of the proposed amendment in slowing the growth in government spending.

Even if a balanced budget amendment were to be ratified, however, Congress would still be subject to pressures from special interest groups to increase spending. And it is the level of spending that determines the burden of government on the economy, since it ultimately has to be financed by taxes in the present, bonds (future taxes), or money creation (inflation or hidden taxes). The intent of a constitutional fiscal policy rule is to make it easier for Congress to say "no" to spending requests because of the knowledge that other expenditures would have to be reduced or taxes raised. But no constitutional rule can eliminate the difficult decisions that will have to be made if the ultimate goals of sustainable economic growth and lower inflation and interest rates are to be achieved.

Douglas L. Bendt

PAYMENTS		MONEY AND BANKING							COUNTRIES
IF li- lars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	central bank rate△	exchange rate in U.S. dollars July 28, 1982	current monetary conditions	
	Current account improved relative to 1981, but outlook now less favorable.	May	+ 6%	April	— 2%	6.75%	.0581	Interest rates set to ease.	Austria
	Poor short-term outlook for rest of Europe reduces export prospects.	May	+ 9%	Dec.	+ 2%	14.00%	.0213	EMS adjustment has temporarily relieved pressure on franc.	Belgium
	Current-account surplus to date is well below 1981, but still substantial.	June	+ 9%	April	+11%	12.06%	1.7350	Bank of England actively forcing interest rates down.	Britain
	June devaluation expected to reverse deterioration of trade balance.	March	+11%	Jan.	+14%	11.00%	.1167	Interest rates have eased slightly since June devaluation.	Denmark
	Jan.-June showed fmk. 1.6 bn. current-acct. surplus vs. fmk. 774 mn. year ago.	May	+10%	Feb.	+19%	8.50%	.2105	Monetary conditions have been eased slightly this year.	Finland
	Current-account deficit FF 12.2 billion in first quarter.	June	+14%	Jan.	+16%	9.50%	.1460	Short-term rates sharply reduced following Franc devaluation.	France
	Terms of trade improving to offset unfavorable export outlook.	June	+ 6%	April	+ 3%	7.50%	.4049	Interest rates expected to decline.	Germany
	Current account expected to improve later in 1982.	Feb.	+19%	April	+ 4%	18.50%	1.4065	Banks see little prospect of early interest-rate fall.	Ireland
	Trade and current-account deficits improving after poor Feb. performance.	June	+15%	Feb.	+ 8%	19.00%	.000728	Money continues tight.	Italy
	Current account continues in substantial surplus.	May	+ 6%	March	+ 5%	8.00%	.3656	Interest rates expected to continue tracking German rates.	Netherlands
	Despite June deficit, 1982 first half still shows kr. 7.38 million trade surplus.	May	+11%	Feb.	+ 9%	9.00%	.1548	Monetary policy remains restrictive.	Norway
	Escudo devaluation should help export competitiveness.	March	+27%	Dec.	+ 9%	18.00%	.0118	Success of recent monetary tightness not yet evident.	Portugal
	Current-account deficit held to $1.4 bn. in first quarter vs. $2.4 bn. in 1981.	March	+14%	Feb.	+14%	8.00%	.00897	M3 accelerating; April year-on-year growth was 16.8%.	Spain
	Balance of payments expected to widen slightly from 1981's kr. 15 billion.	May	+ 9%	March	+ 9%	10.00%	.1629	Riksbank increased cost of funds to commercial banks.	Sweden
	First half 1982 trade deficit sf 2.3 bn. versus sf 3.8 bn. year ago.	June	+ 6%	March	+12%	5.50%	.4819	Money growth picks-up in line with easier policy.	Switzerland
	Jan.-May trade deficit fell to $1.37 billion from $2.98 billion year earlier.	April	+37%	n. a.	n. a.	31.50%	.0060	Securities-firm collapse leaves financial market in turmoil.	Turkey
	Reserves supported by drawings from commerical banks.	June	+11%	June	+ 3%	15.60%	.7917	Interest rates decline slightly.	Canada
	Large monthly fluctuations in trade deficit continue; June deficit was $3.4 bn.	June	+ 7%	June	+ 1%	11.50%	—	Interest rates falling sharply as Fed eases.	United States

△most recently reported

World Interest Rates

market rates as of July 28, 1982; bond yields as of July 23, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.50	15.60	12.0625 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	11.75 July 29	18.50	12.875	14.00	15.00	9.05	20.00	8.625	6.25 1-month Euro-Swiss fr. rate	7.25
Treasury Bills 91-day, Middle Rates	10.66 discount basis	15.20	11.25	14.75	n. a.	n. a.	17.609 92 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	12.00 finance paper discount basis	15.60 finance paper 15% tax w/h	11.012	13.90 Certified	14.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.70	15.55 15% tax w/h	11.3125	13.90 Certified	not traded	9.40	21.60	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	13.31	16.05	12.53	10.47 20% tax w/h	15.33	9.25	20.80	10.35	4.89	8.092
Industrial Bonds prime, long-term, new and old issues, average yield	15.00 Aa Industrials	17.25	13.96	14.405	16.46	9.35	20.38	11.44	5.69	6.60
Bank Short-Term Rate to Best Borrowers (prime rate)	15.50 July 29	17.25	13.00	17.50	16.60	12.00	21.75 ⅛ qtrly fee on outstdng	10.50	9.00	6.00
Bank Time Deposits 3-month	11.625 Cert. of Dep.	15.55	11.8125	14.35	14.75	9.10	11.50	8.875 large deposits	3.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	13.375	16.1875	12.125	no market	16.375	9.0625	no market	9.125	4.500	7.1875
Exchange Rates—in U.S.$ rates floating against the $	—	.7917	1.7350	.0213	.1460	.4049	.000728	.3656	.4819	.0039
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.625 *D*	1.25 *P*	1.00 *D*	3.00 *D*	4.125 *P*	7.50 *D*	4.00 *P*	8.00 *P*	6.25 *P*

Eurodollar Deposits
(London, interbank, bid)
July 29

7-day	11.75
1-month	12.25
3-month	13.25
6-month	14.25

International Arbitrage
(3-month, hedged) ✚ *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.686
U.S.-Canada Treasury Bills	−1.159
U.S.-Canada Finance Co. Paper	−0.761
Eurodollars-U.K. Local Auth. Deposits	+0.250

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.50
Over 7 yrs.	15.25
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.25

Gold Price
London afternoon fixing
347.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(June) 7.1	(June) 11.2	(June) 9.2	(June) 13.6	(June) 5.8	(June) 16.2	(June) 6.2	(May) 2.3
Industrial production*	(June) −9.5	(May) −11.3	(May) 3.7	(May) 0	(May) 0	(May) 2.0	(Dec.) 2.0	(May) 1.4
Trade balance† *(billions of local currency units)*	(June) −$3.44	(May) C$1.36	(May) −£0.12	(June) −FF11.78	(June) DM4.77	(May) −Lit.1,910	(June) −SF0.34	(May) ¥307.5
Money supply (M1)*	(June) 1.1	(June 2.6	(April) 10.9	(Jan.) 16.0	(April) 2.5	(Feb.) 8.3	(March) 12.0	(March) 7.3
Velocity of money (M1)*	(March) −0.4	(Dec.) 17.7	(Dec.) −5.9	(Sept.) −3.6**	(Dec.) 7.1	(Dec.) 7.3	n. a.	(Dec.) −5.2
Reserves minus gold *($ million, change from previous month)*	(May) −630	(June) 78	(May) −414	(May) −1,538	(May) 531	(May) 103	(May) 569	(May) −264

* Percent change from 12 months earlier. **based on GDP † Figures are only for the month indicated.

The Transatlantic Breach

"The problem is that every country is tempted unilaterally to change the trading rules, and broaden the exceptions, as a way to deal with economic crisis. In short, each nation wants the long-term benefits of being part of the international trading system, but at the same time wants the luxury and license to change the rules whenever necessary and pursue its national interest in its own way without regard to consequences for others."

Those words were spoken by U.S. Trade Representative William Brock in February. That was before the steel and pipeline disputes drove a wedge between America and the European Economic Community (EEC). And it was before senior European officials—including British Prime Minister Margaret Thatcher—publicly accused the United States of acting in the very manner alluded to by Brock. But it would be misleading to dismiss this latest trade clash as just another routine conflict. Rather, it reflects a marked widening of the philosophical gulf that separates Europe and America in the economic and political arenas.

On both sides of the Atlantic, there has been an unsettling shift away from accommodation and toward confrontation. An outright trade war is unlikely, since both sides realize the cost would be far too high. But if trade tensions are not defused—and quickly—the long-awaited world economic recovery may be delayed and weakened. Moreover, other areas of potential U.S.-EEC cooperation – including proposals that will come up at the November trade ministers' meeting of the General Agreement on Tariffs and Trade (GATT) – may be jeopardized. This little-publicized but critical session of the international trade watchdog in Geneva could be instrumental in warding off protectionist pressures, a vital task if the international economic system is to be preserved. Economists have long argued that trade barriers misallocate resources and lead to a cycle of declining real earnings, reduced saving and capital formation, slower economic growth, and higher prices.

Steel duties and the pipeline embargo

The most recent deterioration in transatlantic relations was touched off in June when the Commerce Department tentatively determined that EEC steelmakers, aided by government subsidies, were undercutting U.S. steel companies. That paved the way for hefty countervailing duties—ranging up to 40%—which for some leading European companies would be tantamount to banishment. Europe's pique was then compounded by the unexpected U.S. decision to broaden the restrictions on the export of technology for the planned Soviet-European natural gas pipeline, to include U.S. corporations' foreign subsidiaries and European companies manufacturing under U.S. license. Now the EEC is hinting at retaliation.

From the U.S. point of view, these were two isolated moves: The steel duties resulted from legal proceedings that left government officials little flexibility, while the extended pipeline sanctions reflected the President's desire to put pressure on the Kremlin over Poland. But across the Atlantic, the actions were viewed quite differently. Americans appeared headed down the road of economic nationalism, still lacking a coherent foreign economic policy. In the case of steel, Europe accused the United States of unilaterally—and incorrectly—interpreting the new GATT subsidies code. According to the EEC, America has failed to distinguish between grants used for restructuring and those used for current operating expenses. The EEC also fears that, ironically, the offsetting duties could undermine its program to phase out steel subsidies by 1985. And the EEC interpreted the U.S. pipeline decision as an attempt to exercise "extraterritorial" political control, besides raising questions about America's reliability as a supplier.

European leaders are counting on the pipeline to reduce energy dependence on the Middle East, to bolster trade, and to create jobs. The OECD forecasts that European unemployment will rise to 10.5% next year from the current post-war high of 9.75%. And this comes at a time when only an anemic world recovery is expected, industrialized nations are having trouble adjusting to growing competition from the newly industrialized nations, and world trade is limp. In 1981, the value of trade declined for the first time since 1958, and the volume, after having risen by only 1% in 1980, stagnated. In Europe's view, things would not be quite so grim if U.S. policies had not driven interest rates sky-high and if the dollar had not been abandoned to soar.

But U.S. officials are not about to take the blame for Europe's economic woes, especially at a time when U.S. unemployment is up to 9.5%, farm incomes are quite low, and some recession-struck industries, such as steel, are running at severely depressed capacity levels. For years, the United States has complained that government handouts—not only in industry but in agriculture—have given European exporters an unfair competitive edge both here and in other non-EEC markets. Now, the Reagan administration seems determined to convince Europe that in an integrated world economy, government intervention in one nation necessarily affects other nations. In America, there is a tendency to offer protectionist assistance to industries thought to be of strategic economic importance, or to those that employ large

The Transatlantic Breach *(continued from page 7)*

numbers of workers; but handouts are frowned upon. Subsidies tend to distort income distribution and economic efficiency, much as tariffs and quotas do. European leaders, however, are much more sensitive to electoral pressures to subsidize strategic industries in competitive difficulties. Even the Germans, who regularly chastise their fellow EEC members for handouts, are becoming more interventionist—as shown by recent aid for troubled industrial giants.

Given this rather deep philosophical divide, how can trade tensions be defused? In the steel dispute, the two sides may yet reach an accord on volume or price, but time is short. As for the pipeline, the United States could forgo trying to enforce the sanctions. Or Europe could toughen its East-West stance, enabling the Reagan team, as part of its current foreign economic policy review, to bend a little.

The November GATT meeting

Even if these disputes are settled, however, other trade conflicts undoubtedly will surface. That is why Brock has poured so much energy into promoting the November GATT session—the first annual meeting to be held at the ministerial level in nine years. For the 87 member nations, it is a valuable political chance for reaffirming their commitment to resist shortsighted protectionist pressures and to observe the rules of the GATT. Underlying the multilateral treaty is the principle that trade privileges offered to one country should be extended unconditionally to all nations. For years, however, the GATT has been weakened as nations have ignored and undermined its rules. Major areas of trade—steel, shipbuilding, automobiles, and agriculture – now fall under special arrangements, such as "voluntary" restraint agreements, that circumvent the GATT. The challenge, then, is how to strengthen the GATT.

The United States is taking the most activist and optimistic approach by pushing for the GATT to embrace new areas—such as trade in services, capital movements, high technology, and trade-related investments. Otherwise, U.S. trade policymakers warn, nations will increasingly resort to bilateralism. So far, the administration has managed to water down a congressional "reciprocity" bill—aimed at Japan—that would have allowed America to retaliate against nations that did not give U.S. goods and services substantially equivalent market access. But other bills are in the works, even though, as the GATT has pointed out, trade and payments imbalances between any two countries are not a problem in a multilateral trading system with convertible currencies. Nor is bilateral reciprocity a problem in a trading system based on a pledge of unconditional most-favored-nation treatment.

America also insists that the GATT at long last attack the most heavily protected area of trade: agriculture. Here it enjoys strong support from Australia and New Zealand, which have questioned the value of membership if the GATT fails to tackle their overriding trade concern. And America is adamant about overhauling the "safeguard" provisions for coping with a sudden flood of goods that threaten serious injury to domestic producers. U.S. suggestions include improving notification procedures and bringing the various bilateral pacts and inter-industry cartels into the GATT framework so that these arrangements can at least be internationally policed.

But for the United States to push through such an ambitious action program for the 1980s, it will need the EEC's support. The EEC, however, has indicated that its qualified backing might be withdrawn if the steel and pipeline disputes are still unsettled. Even if tensions are defused by then, Europe worries that the GATT will be hard put just to hold the trading system together, and that these new initiatives pose as many snares and pitfalls as they do opportunities. The EEC is also reluctant to let the GATT touch its political hot potato: export subsidies and price supports for agricultural products.

As for the less-developed nations (LDCs), they are pressing in the GATT for greater access to markets and for security of that access. For years, the LDCs have questioned the GATT's relevance. Now, in light of the world economic malaise, they are seeking ways to strengthen it. But they have not expressed enthusiasm about the U.S. push to break new ground. The LDCs are suffering from sluggish export demand, depressed raw-material export prices, mounting foreign debt, and growing protectionist pressures. Should these pressures intensify because of U.S.-EEC-Japan sniping, the LDCs might get caught in the crossfire.

In sum, November could be a turning point for the GATT. With tensions between the major trading partners perhaps the worst in its 35-year history, members have a chance to make the agency more than just a forum for consultation, negotiation, and public pressure. A successful meeting could spell a possible turning of the tide against creeping protectionism and continued stagnation in trade and could provide an improved environment for a world economic recovery. On the other hand, failure—or agreement on nothing more than a meaningless trade pledge and an action program devoid of substance—could signal a further weakening of the trading system and business confidence. It is encouraging that the member nations have turned to the GATT for help. But they will have to rise far enough above their parochial interests to make a difference.

Laura K. Wallace